BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	)	
	)	No. 90A-0554-MC
American Biltrite Inc.	)	

Appearances:

For Appellant: Paul Frankel
Attorney at Law

For Respondent: H. Kent Holman
Counsel

O P I N I O N

This appeal is made pursuant to section 25666[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of American Biltrite Inc. against proposed assessments of additional franchise tax in the amounts of $4,606 and $8,867 for the income years 1975 and 1976, respectively.

[1/] Unless otherwise specified, all section references are to the Revenue and Taxation Code as in effect for the income years in issue.

Appellant, a Delaware corporation headquartered in Massachusetts, operates a variety of divisions which produce assorted products such as vinyl flooring and tile; rubber soles and sheets; hoses for automotive, fire, industrial, hydraulic, and garden uses; tapes for athletic, "friction," and electrical uses; and plastic bottle caps for milk cartons. In addition, appellant has three affiliates. Two of the affiliates are involved in the overseas manufacture and sale of products similar to those manufactured and sold by appellant. It is the sale of the stock of the third affiliate, American Synthetic Rubber Corporation (ASRC), that is the source of this appeal.

During World War II, the U.S. government built several synthetic rubber factories. After the war, these plants were sold to major rubber companies. During the 1950s, appellant, along with several other companies, all apparently not tire manufacturers, formed ASRC with the purpose of acquiring a synthetic rubber plant to operate as a source of supply for certain smaller users of synthetic rubber. To insure that the company was available as a source of supply for all shareholders, two provisions were adopted.

The first mechanism was the creation of four classes of stock, with three of the classes of stock being entitled to vote for three directors each, and the fourth class being entitled to vote for one director. There was then an eleventh at-large director. (How this director was selected is not explained.) The separate classes of stock effectively prevented any one shareholder from controlling the board. Although both parties agree this is a factually correct conclusion, neither party explains the mechanics of this provision. We assume that each shareholder was limited to voting for one class of directors notwithstanding the number and class of shares actually owned, such that no shareholder could gain control of the board of directors. As part of the class structure, there was a buy-sell arrangement within and among the classes which required the shares to be offered to other shareholders before they could be sold to an outsider. The second mechanism adopted to ensure that ASRC operated as a source of supply to its shareholders was a provision which entitled shareholders to purchase ASRC's production in proportion to their stock ownership. The price for these purchases is not specified.

During the 1950s and 1960s, ASRC was a significant source of supply of synthetic rubber for appellant. At the time of the disposition of the ASRC stock, appellant purchased 13.5 to 17 percent of ASRC's production. Appellant used approximately 29 to 36 million pounds of synthetic rubber for the years in question and only two or three million pounds came from suppliers other than ASRC. (App. Ltr. Br., Oct. 9, 1991, p. 2.) Appellant purchased the synthetic rubber from ASRC because ASRC offered a good price and the plant was close to two of appellant's plants, thus reducing freight costs. (App. Ltr. Br., Oct. 9, 1991, p. 3.)

ASRC's annual production was approximately 200 million pounds. Under the stockholder agreement, appellant could have purchased up to 55 percent of the output of ASRC. However, appellant did not do so, and in 1975, about 66 percent of ASRC's output was sold to tire manufacturers. In 1975, worldwide production of synthetic rubber was approximately 5.1 billion pounds, a reduction from 1973 production of 6 billion pounds. In addition, domestic supplies of synthetic rubber had dropped substantially and suddenly during 1974 and 1975. (App. Ltr. Br., Oct. 9, 1991, Ex. B.)

In 1972, 1973, and 1975, four of ASRC's directors were also directors of appellant. In 1974 and 1976, three of ASRC's directors were also directors of appellant. During these years, appellant had 10 directors. ASRC had 10 directors in 1972 and 1976, 11 directors in 1973 and 1975, and 8 directors in 1974. Thus, in none of these years did appellant have majority control of ASRC's board of directors. None of ASRC's officers or directors were officers of ASRC. It also appears that management of the operations of ASRC was independent of any of its shareholders.

During both of the years in question, appellant sold a portion of its ASRC stock for a gain. This reduced appellant's ownership of ASRC from 39 percent to 21 percent. (During the first year in question, appellant actually acquired an additional 5 percent of ASRC shares before it sold some of its ASRC shares later in the year.) Appellant reported the gain as nonbusiness income allocable to its place of business, apparently Massachusetts. Respondent examined appellant's returns and determined that the income was business income to be apportioned to all the states in which it did business, including California. Appellant protested, respondent disallowed the protest, and this appeal followed.

The sole issue to be decided is whether the gain from the sale of the ASRC shares generated apportionable business income or allocable nonbusiness income. Section 25120, subdivision (a), defines business income as:

> income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

Nonbusiness income is defined simply as all income other than business income. (Rev. & Tax. Code, § 25120, subd. (d).)

Section 25120 provides two alternative tests to determine whether income constitutes business income. The first is the "transactional" test. Under this test, the relevant inquiry is whether the transaction or activity which gave rise to the income arose in the regular course of the taxpayer's trade or business. Under the second or "functional" test, income from property is considered business income if the acquisition, management, and disposition of the property are "integral parts" of the taxpayer's regular trade or business operations, regardless of whether the income was derived from an occasional or extraordinary transaction. (Appeal of DPF Incorporated, Cal. St. Bd. of Equal., Oct. 28, 1980; Appeal of Fairchild Industries, Inc., Cal. St. Bd. of Equal., Aug. 1, 1980.) If either of these two tests is met, the income will constitute business income. (Appeal of DPF Incorporated, supra.) Respondent's determination as to the character of income to a business under either test is presumed correct, and the taxpayer has the burden of proving error in that determination. (Appeal of Johns-Manville Sales Corporation, Cal. St. Bd. of Equal., Aug. 17, 1983.)

This appeal involves application of the functional test for determining business income under section 25120. The statute provides that gain from the sale the ASRC stock is business income if the acquisition, management, and disposition of the stock are "integral parts" of the taxpayer's regular trade or business. (Cf. Allied-Signal, Inc. v. Director, Division of Taxation, -- U.S. --, 119 L.Ed.2d 533 (1992) (the investment must "serve an operational rather than an investment function").) In this case, there is no doubt that the acquisition and management of the asset, at least in the 1950s and 1960s, was an integral part of appellant's business. ASRC was a crucial source of supply of synthetic rubber for appellant. The very purpose for acquiring ASRC was to ensure a supply of synthetic rubber and to prevent tire manufacturers from controlling this source of raw material. However, it is the nature of the holding of the asset at the time of its disposition which is crucial to determine the character of the gain. (Appeal of Occidental Petroleum Corporation, Cal. St. Bd. of Equal., June 21, 1983.) Thus, stock which was acquired and managed as an integral part of appellant's business could have the nature of its holding change such that, when disposed of, it was investment property. However, for us to reach such a conclusion, there must be some objective evidence supporting the alleged change in the nature of the taxpayer's holding of the asset. (Cal. Code Regs., tit. 18, reg. 25120, subd. (c)(2).)

In the instant case, there is no objective evidence that the nature of the holding of the ASRC stock changed so significantly that the holding of the stock was no longer an integral part of appellant's business. On the contrary, the facts indicate that the ownership of the stock continued to play an integral role in ASRC's business. ASRC provided over 90 percent of the synthetic rubber used by appellant in its manufacturing activity. Synthetic rubber consisted of approximately 22 to 24 percent of appellant's total use of rubber. In our opinion, a single source of supply of about 20 percent of a manufacturer's raw materials is so significant that ownership of the supplier's stock is an integral part of the manufacturer's business.[2/]

We think this case is analogous to the factual scenario described in Appeal of Standard Oil Company of California, decided by this board on March 2, 1983. Standard Oil involved the characterization of dividends received from two joint venture affiliate corporations, Aramco and CPI. Standard Oil owned less than a 50-percent interest in Aramco and CPI. They served as major sources of supply for Standard Oil's worldwide activities related to the acquisition and disposition of crude oil, natural gas, and refined petroleum products, supplying approximately 50 percent of Standard Oil's raw materials. The effect of various shareholder agreements concerning access to production and the payment of dividends indicated that Aramco and CPI were created to ensure a supply of oil to Standard Oil and that the dividend payments were unrelated to the percentage of stock owned in the affiliates. We found that Aramco and CPI were created and maintained in furtherance of and as an integral part of Standard Oil's unitary business. Standard Oil's ownership of Aramco and CPI was not a passive investment separate and apart from its unitary business. In essence, ownership of the stock had operational significance.

[2/] This is not to say that the stock of a major supplier could never be held as an investment. To make such a showing would require strong evidence of an investment purpose, a showing which appellant has not made.

Standard Oil was supplied a much larger percentage of crucial raw materials by Aramco and CPI than was appellant by ASRC. However, the percentage of synthetic rubber supplied to appellant by ASRC was over 90 percent of appellant's use of that specific raw material. In addition, the proximity and pricing offered by ASRC made it an attractive supplier for appellant. There is no evidence that these factors no longer played any role in appellant's continued ownership of the ASRC stock.

Appellant argues that the world supply of synthetic rubber had grown so large that ASRC was no longer a crucial supplier. It avers that if ASRC was not a supplier, it would acquire the synthetic rubber elsewhere. While these are certainly possibilities, the facts show that ASRC continued to be the nearly exclusive supplier of synthetic rubber to appellant. The possibility that other suppliers were available does not constitute objective evidence that the nature of the holding of the ASRC stock clearly changed to an investment. (Cf. Cal. Code Regs., tit. 18, reg. 25120, subd. (a).) Lacking clear evidence of a change in the purpose of holding the ASRC stock, we conclude that this stock continued to play an integral part of appellant's business operations.

We find that appellant's acquisition, management, and disposition of the ASRC stock were integral parts of appellant's unitary business. For the reasons stated above, respondent's action with respect to appellant's protest against additional assessments of franchise tax must be sustained.

ORDER

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED, AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of American Biltrite Inc. against proposed assessments of additional franchise tax in the amounts of $4,606 and $8,867 for the income years 1975 and 1976, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 19th day of November, 1992, by the State Board of Equalization, with Board Members Mr. Sherman, Mr. Dronenburg, Mr. Fong, and Ms. Scott present.

Brad Sherman, Chairman

Ernest J. Dronenburg, Jr., Member

Matthew K. Fong, Member

Windie Scott*, Member

_____, Member

*For Gray Davis, per Government Code section 7.9

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